December is the perfect month to take a step back, relax and reflect on the events of the past year. And while we most certainly do not wish to ruin your holiday season by juxtaposing the thought of taxes with the visions of sugar plums dancing in your heads, this is also the perfect time of year to consider the long- and short-term tax implications of your company’s 2011 activities and transactions. Specifically, if you have not considered the tax impact of your company’s 2011 acquisitions, there is no time like the present.

Instant unity is likely not the first thing that comes to mind during this review process. However, from a state and local tax perspective, the consequences of instant unity may have a significant impact on your upcoming state income and franchise tax filings, estimated payments and year–end tax provision analysis. In this edition of Tax Advisor Weekly, we discuss the concept of instant unity, highlighting a selection of the reasons why your company should review its recent acquisitions to ensure they are receiving the proper unitary treatment for state tax purposes.

With Instant Unity, Timing Is Everything
The unitary business principle is a cornerstone of state and local taxation (discussed in additional detail in Tax Advisory Weekly Issue 49 2010, ""). As the United States Supreme Court declared in Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980), “the linchpin of apportionability in the field of state income taxation is the unitary-business principle.” That is to say, absent a unitary relationship to a taxpayer’s business, the state income tax treatment of an item of income must be determined separately from that of the taxpayer’s unitary business income.

The Court further established that a unitary relationship exists when there is functional integration, centralized management and economies of scale. Additionally, as the Court indicated in Container Corporation of America v. Franchise Tax Bd., 463 U.S. 159 (1983), a "flow of value" between business activities is often evidence that a unitary relationship exists.

The issue of instant unity most often arises in the context of one entity’s acquisition of either another entity or an asset. Unlike a plain–vanilla unitary analysis, instant unity is an inquiry that does not answer the question of whether entities are unitary, but rather, when they become unitary. For example, when one entity acquires another entity that engages in a similar line of business, it is often clear that a unitary relationship will eventually develop between the companies. However, the relevant question in the context of instant unity is whether the unitary relationship developed immediately (or instantly) upon acquisition or was forged over the course of weeks, months or even years. As will be seen in the cases discussed below, courts have sometimes found that a period of time must elapse subsequent to an acquisition before the indicia of a unitary relationship, such as centralized management or administrative functions, are formed. When it comes to exploring the concept of instant unity, timing is everything.

California Leads the Way
As is the case in many areas of state taxation, California has provided the greatest amount of guidance on instant unity. Below is a brief discussion of three California decisions that have addressed instant unity and the conclusions they reached.

- Appeal of the Signal Companies, Inc., 90–SBE–003 (California State Board of Equalization, 01/24/1990): In this decision, the California Board of Equalization (BOE) indicated that a unitary relationship is developed over time, and not as the result of a single event. Notably, in its decision, the BOE stated that “unity is almost never demonstrated by some single event, but is a conclusion drawn from the aggregation of connecting factors between entities.”
• Appeal of Boston Scientific Corp., No. 244315 (California State Board of Equalization, 02/08/2005): In this 2005 letter decision issue by the California BOE, the Franchise Tax Board (FTB) focused on considerable pre-acquisition planning and the almost immediate incorporation of executives between the two entities to support the argument that instant unity existed as of the acquisition date on April 8, 1997. However, the California BOE ultimately ruled that the companies were unitary as of July 1997, about three months after the initial acquisition. At that point, the companies had completely consolidated departments, integrated executive staff, and centralized production, distribution and their general system of operation.

• Appeal of Dr. Pepper Bottling Company of Southern California, National Drinks Leasing Co., Inc., and National Drinks Bottling Co., Inc., 90–SBE–015 (California State Board of Equalization, 12/05/1990): In this case, the California FTB and BOE held that Dr. Pepper Bottling Company of Southern California was instantly unitary with Dr. Pepper Company as of the acquisition date. The BOE based this decision on the fact that a "vertically integrated enterprise was pre–existing here, needing only unity of ownership to result in a unitary business." Additionally, the BOE noted that "immediately upon acquisition" Dr. Pepper Company replaced all of the bottling company's officers and directors with its own people, and sent a Dr. Pepper Company employee to California to serve as the bottling company's president.

Other states have also addressed instant unity, although not to the extent that California has vetted the concept. Much like the position California has taken, Michigan recognizes that instant unity may occur, depending upon the taxpayer's specific facts and circumstances. In Michigan Revenue Administrative Bulletin 2010–2 (02/24/2010), the Michigan Department of Treasury indicated that a "unitary relationship may take time to develop whenever an entity acquires another. This may be so even if the entities are in the same business and are complementary. . . . In contrast, the acquisition of an entity where there was a pre–existing relationship may support a finding of an instant unitary relationship." The Department also indicated that "a financial infusion of capital, the transfer of personnel, transfer of intangibles and knowledge, pooling of expertise, pooled marketing and shared use of established policies, procedures and administrative plans" are indicia of the existence of an "'instant' unitary relationship." Similarly, the Illinois Department of Revenue has indicated that instant unity "requires some existence of a pre–existing relationship between a newly acquired subsidiary and its parent before the subsidiary can be included in the unitary group." The Department of Revenue of the State of Illinois v. XXXXXXXX Cellular Holding, Inc. et al., IT04–7, (12/31/2003).

While the facts of each of the above cases are distinct, one common theme is that some amount of pre-acquisition planning must occur for two entities to become instantly unitary upon acquisition. Moreover, the cases illustrate that the determination of whether instant unity exists is truly a case–by–case, facts–and–circumstances determination.

Enterprise vs. Asset Unity
As mentioned earlier, the issue of instant unity most often arises either when one entity acquires another entity or when an entity acquires an asset. While much of the guidance addressing instant unity does so specifically in the context of entity acquisitions, instant unity also applies to the determination of when acquired assets become a part of the acquirer's unitary business.

In the asset acquisition context, the underlying test for unity is not the more familiar test used to determine enterprise unity ---- i.e., functional integration, centralized management and economies of scale ---- but rather the operational–function test. The Court in Allied–Signal, Inc., v. Director, 504 US 768 (1992) described the operational–function test as an inquiry that "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." Therefore, before reviewing whether an asset is instantly unitary with an entity upon acquisition, it is first important to apply the operational–function test to determine whether the asset could ever be unitary with the acquiring entity.

Alvarez & Marsal Taxand Says:
In most cases, states follow the federal treatment of the IRC Section 338(h)(10) election. Even with the general acceptance of the election by most states, there are still several issues, as discussed above, that may impact the decision to make an IRC Section 338(h)(10) election. A thorough analysis of a state’s position on business versus nonbusiness income should be made, along with a subsequent determination of the sales factor and tax attribute treatment under an IRC Section 338(h)(10) election.

In any acquisition where an IRC Section 338(h)(10) election is being considered, it is crucial to consider the income tax benefits and detriments not only from a federal perspective but also from a state perspective.

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